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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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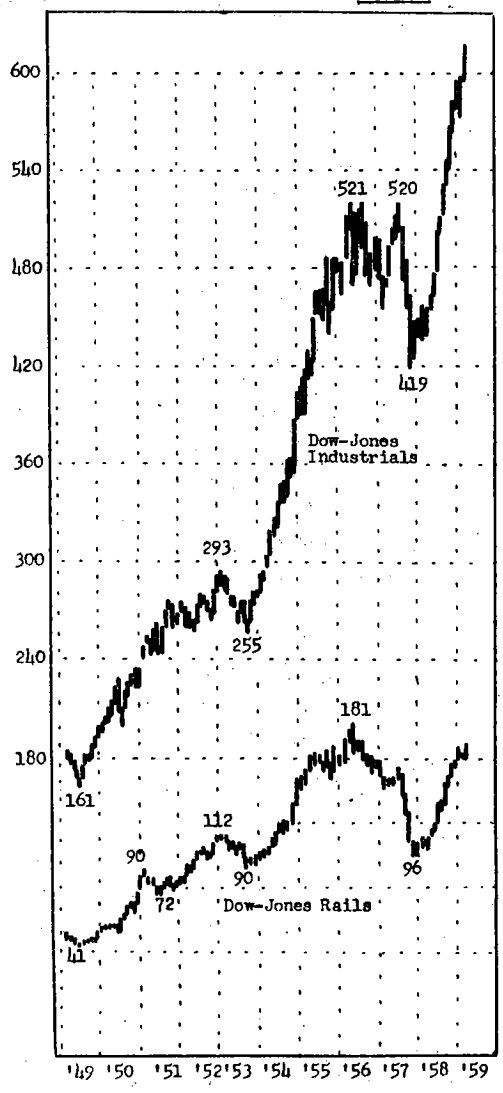
WHERE ARE WE? Occasionally a navigator likes to take his eyes off the terrain directly below and study his charts for the larger picture. If we follow his example (see chart below), it becomes apparent that this market has come a long way since the primary trend first turned up in 1949. We note, however, that the last confirmed highs were established in 1956. At that time the rails confirmed the 521.05 industrial highs by going to new bull market highs themselves (181.23). According to classical Dow Theory the final top of a bull market is that point where the last confirmed highs occured. This brings us to a technical matter- but an important one. If, for the sake of argument, rails do not better their 181.23 highs of 1956 prior to a final topping out of this market, we will then have to reclassify the entire advance since October, 1957, as a reaction (upwards) in a bear market which has been in effect since the last confirmed highs in 1956- an idea which strikes me as rather grotesque. Should the market top out prior to this final rail confirmation, it would mark an event unprecedented in stock market history. For it would be the first time that a spectacular advance (with all the earmarks of a bull market's third phase) was not accompanied by a final advance of both averages over previous bull market highs.

Now if we assume that rails will better their 1956 highs, we can say that they must advance about 10% from their present levels. This gives us a logical measuring device. I believe that if rails do climb 10%, and in so doing better their former 181.23 bull market highs, industrials should do at least as well. Therefore I estimate that the minimum move that industrials should make before a final topping out is another 10% or about 690 on the D-J industrial average. Of course, this does not have to occur without a prior reaction, and it is a calculation based on pure theory. However, I feel that 690 represents a logical minimum under this hypothesis, and I happen to believe that the hypothesis is a valid one.



THE OTHER SIDE OF THE COIN. Many readers have asked how far I think the next bear market could go on the downside. Here again we get into some interesting theory. We know, by definition, that in the first phase of a bull market stocks rebound from the depressed levels of the previous bear market and return to known values. Studying our charts again, we note that during the first phase of the current bull market industrials advanced from 161 to 293. But since every primary swing tends to overrun itself, we can say 293 took stocks past known values. The correction of the first primary swing returned industrials to 255, which should have represented actual values in the year 1953. If we allow 3% for growth and inflation during each year since 1953 we arrive at 313 as the actual value of the D-J industrial average as 1960.

A bear market's third phase, by definition, returns stocks below known values. If this is true, then the next bear market (which should correct the entire primary swing from 161 in 1949 to the final top) could also take industrials back

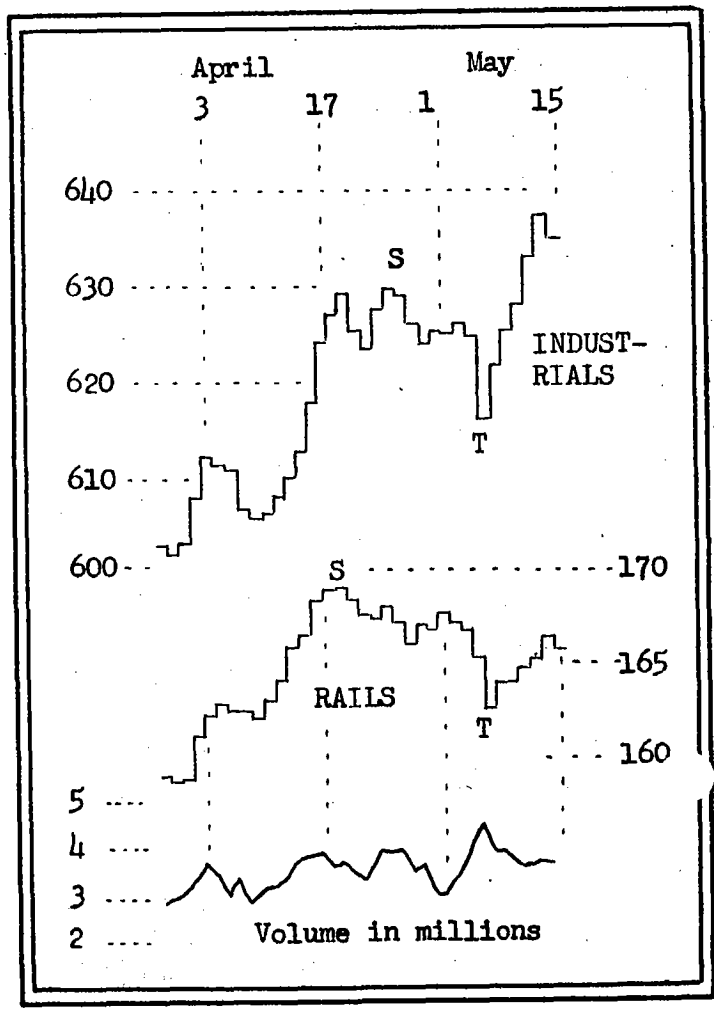
below known values or well below 313! "Below 313" may sound unthinkable, but let me remind readers that the pinnacle of the 1942-46 bull market was registered by industrials at 212. History tells us that the longer and greater the period of inflation, speculation, and excess, th more severe the final correction. If this thesis is valid, then we have a two-fold reason fo believing that the next bear market could be more drastic than anything the economists now visualize. What might cause such a collapse only the historians of 1970 will know. This writer, however, has long been skeptical of the "fabulous Sixties".

PRICE MOVEMENTS. The action of the market since our last Letter illustrates the extremely difficult problem which the trader faces in contrast to the more complacent long-term investor, that of attempting to protect himself against a possible reaction while at the same time riding out the best part of a long bull swing. Letter 65 stated that upon a violation of the "line" downside on increased volume "traders can protect themselves by taking profits. Long-term investors can hold their stock on the basis of the primary trend's continuing to point up."

The ensuing high-volume (4 1/2 million shares) breakthrough of the line sent industrials down to the tune of 8.75 points (T on chart) while rails dropped 2.63 points (T). Yet that was apparently all the selling this market was ready to do. Since the panicky drop industrials have climbed 21.39 points to a new bull market high of 637.04. Rails advanced 3.72 points which placed them back within the lower limits of the last line. Friday saw a one day decline on hopefully lower volume. The market action during the recent week was extremely deceptive, and it is worth noting that on the two selling days volume hit 4.1 and 4.5 million while on the advance since the T points volume averaged 3.7 million. In fact during the first four days of the advance volume actually diminished. Therefore, there is still something in the whole volume picture which bears watching. Volume, of course, should tend to expand on an advance, and market technicians like volume to increase progressively as a primary swing continues higher.

All of this may sound like searching for needles in a haystack, but after an uncorrected primary swing of over 50% (218 points) in 18 months, past precedent tells us to be on the alert. I know of no primary advance in stock market history which was not eventually corrected by a secondary reaction.

The action of the rails has again been sluggish, and although they have been "in gear" (moving in the same direction) with industrials, they must now confirm the industrial breakthrough by bettering their 168.92 highs which were recently established at point S. There is no time limit on this confirmation, but the persistant refusal of one average to confirm the other has been a danger signal in the past. If, on the next decline, one or both averages hold above the lows at T (industrials 615.65, rails 162.58) and volume tends to diminish on the decline, the general picture will be bullish, and we can infer that the next direction of the market will be up. But if volume tends to increase on the decline, and both averages then violate the T points on high volume it would be the most alarming move in the last eighteen months. At that point I would say that the secondary trend had turned down, and that traders were entitled to step to the sidelines. It has been my policy all along to advise long-term investors to sit tight, and I continue to advise this. They should not sell until the entire



market shows sufficient danger signals to imply that a final topping-out is at hand. That point has not yet arrived. It is perhaps significant that as this market works higher we are not getting the clean-cut, technically satisfactory moves which we received six months or a year ago. Readers who followed this market up with me last year know that there were few if any periods then when we had to "sweat out" a move. It was easy to sit with fat portfolios all during 1958 when the news and the crowd were bearish, but that is not the case now nor has it been since January of this year.

Rails have been fluctuating within a narrow 11 point range since January of this year. It is possible that this entire area represents a period of accumulation. If this is the case, there should eventually be a concerted advance in rails shares, and it is my hunch that such a phenomonon would bring out greater volume than anything seen so far in this bull market. A convincing rail rally might signal the beginning of the 5-6-7 million share days which I have written about and predicted (see Letters 60 and 65), but which have not yet appeared. Many analysts believe that it will take some sort of a reaction before the crowd can be persuaded to enter the market en masse. This may be true, but I feel that it has been the hesitant rail action which has been holding this market back for four months now. Upside momentum in the carriers could change the entire volume picture.

An interesting sidelight is that on the sell-off last week odd-lot shorts zoomed to 5,280 shares, their highest day in eight months. However, the odd-lot shorts will normally step up operations on the first drop, and I prefer not to attach undue significance to this figure.

STOCKS. Considering the general market picture and the extent of the uncorrected primary swing, I do not wish to recommend stocks for purchase at this time. I do this fully realizing that most popular services always have a few dozen stocks on their "buy" list. Under my interpretations of the Dow Theory I feel that the chances of picking the wrong stock or the wrong group or of buying a month or so away from a reaction outweigh the possibilities of making brilliant new commitments at this time. In the advent of a decline it seems to me that chemicals are one of the strongest groups, and such stocks as DuPont, Olin-Mathieson, Dow, Grace, Monsanto, and Heyden-Newport will out-perform the market. They could well be leaders on the next move up. I used last week's rally for selling weaker numbers, and I was not impressed by the belated rise in steel shares. Interest in low-priced stocks is diminishing, and this could foreshadow a general slowing down of speculative interest.
(written May 17, 1959, 3 P.M.)

NOTICE. Readers might be interested in my Dow Theory article scheduled for this week's BARRON'S. It discusses the interpretation of the price movements as encountered in the course of an entire bull and bear cycle. I do not believe that an article of this type has ever appeared before in a national publication.

Dow Jones Averages.

Thirty Industrial Stocks

Allied Chemical	General Electric	Procter & Gamble
American Can	General Foods	Sears Roebuck
Am. Smelting	General Motors	Std. Oil of Calif.
Am. Tel. & Tel.	Goodyear	Std. Oil of N. J.
Am. Tobacco	Inter. Harvester	Texas Co.
Bethlehem Steel	Inter. Nickel	Union Carbide
Chrysler	Inter Paper	United Aircraft
Corn Products	Johns-Manville	U. S. Steel
du Pont	Nat'l Distillers	Westinghouse El.
Eastman Kodak	Nat'l Steel	Woolworth

Twenty Railroad Stocks

Atchison	Erie	N. Y. N. H. & Hart.
Atl. Coast Line	Great North	Norfolk & Western
Balt. & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So.	Southern Pacific
Ches. & Ohio	Louis. & Nash.	Southern Rwy.
Chi., R. I. & Pac.	N. Y. Central	Union Pacific
Del & Hudson	N. Y. C. & St. L.	